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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

DISCHARGE FOR A REORGANIZING CORPORATION—BEWARE OF THE FORGOTTEN CREDITOR

Chapter 11 of the Bankruptcy Code was designed to give corporate debtors a broader discharge of debts than is available to individual debtors. Individuals are subject to the exceptions to discharge set forth in Section 523(a) of the Code, such as for debts incurred by fraud, liabilities for willful injuries or embezzlement, alimony and child support obligations, and others.[1] However, confirmation of a reorganization plan discharges the corporate debtor from *all* debts that arose prior to confirmation without regard to Section 523(a).[2]

The less favorable treatment afforded individuals in chapter 11 is based on the principle that a discharge is intended only for the honest debtor and that an individual should be held accountable for his past wrongdoings. However, it makes sense to discharge such debts in cases of corporate reorganizations because dishonest management will most likely be replaced, and it will be undesirable to penalize new management, as well as shareholders and creditors, for the unscrupulous conduct of former employees. Therefore, even debts incurred by fraud will be discharged in corporate cases.

Another manifestation of Congress's intent to give the corporate debtor the broadest possible discharge is by insulating the reorganizing corporation from the effects of Section 523(a)(3). This is the section that excepts from an individual's discharge any debt "neither listed nor scheduled under Section 521(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit . . . timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the

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[1] See 11 U.S.C. § 1141(d)(2). See 11 U.S.C. § 523(a) for the list of specific exceptions.

[2] See U.S.C. § 1141(d)(1). This broad discharge provision also is applicable to partnerships in chapter 11.

case in time for such timely filing. . . ."[3] Under the Code, even those debts that are unscheduled are discharged in a corporate reorganization, whether or not the creditor knew that the case was commenced.

Reliable Electric Co., Inc.

This background leads us to the recent decision of the court of appeals in *Reliable Electric Co., Inc. v. Olson Construction Co.*,[4] where the court indicated that Congress was a bit overzealous in attempting to remove as necessary conditions to a discharge notice to creditors by the best available means with respect to the filing of the case and the confirmation hearing.

Reliable involved a chapter 11 debtor which was an electrical subcontractor working on a construction project where Olson Construction Company was the general contractor. Reliable had withdrawn from the project in December 1979 because it felt that Olson had breached the subcontract. On January 30, 1980, Reliable filed its chapter 11 petition. In its schedules in bankruptcy Olson was listed under the schedule "Accounts Receivable" but never as a "Creditor."

Some time between January 1980 and November 1980, Reliable's attorney telephoned Olson's attorney and informed him of Reliable's filing. However, Olson did not receive any further information from Reliable concerning the proceedings. On November 9, 1980, Reliable sued Olson in state court in Colorado seeking damages for breach of the subcontract. In December 1980, Olson removed the action to the bankruptcy court[5] and asserted a counterclaim for damages based upon Reliable's prepetition breach of the subcontract.

On January 6, 1981, Olson filed its Third Amended Plan of Reorganization. The Disclosure Statement[6] annexed to the Plan stated that both the Plan and the Disclosure Statement had been sent to all of Reliable's known creditors. On January 13, the bankruptcy court mailed notice to the scheduled creditors informing them of the time for filing acceptances or rejections to the Plan, of the confirmation hearing, and the time for filing objections to confirmation.[7] The confirmation hearing was conducted on March 9, 1981. An order was thereafter entered confirming the Plan and notice of the confirmation and discharge of Reliable was sent to the scheduled creditors. Since Olson was not a scheduled creditor, it did not receive any of the notices.

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[3] 11 U.S.C. § 523(a)(3).

[4] 726 F.2d 620 (10th Cir. 1984).

[5] See 28 U.S.C. § 1478.

[6] See 11 U.S.C. § 1125.

[7] See Bankruptcy Rule 2002 regarding notice requirements.

In August 1981, almost ten months after the suit was instituted by Reliable against Olson in which Olson filed a counterclaim against Reliable, a trial was held on the subcontract dispute and the bankruptcy judge dismissed Reliable's complaint and granted judgment for Olson on its counterclaim for $10,378. Reliable then filed a claim in the chapter 11 case on behalf of Olson for that sum.[8] Reliable also filed a motion to allow the claim as a prepetition debt "subject to compromise and payment as a general unsecured claim under the confirmed Plan of Reorganization and, thus, subject to discharge."[9]

However, the bankruptcy court issued an order finding that because Reliable failed to schedule Olson as a creditor, and failed to notify Olson of the confirmation hearing, "and because Olson's claim would be substantially impaired without due process of law if it were forced to comply with the Plan, Olson's claim was not subject to the confirmed Plan and, therefore, not discharged."[10] The district court on appeal affirmed the bankruptcy judge.

The court of appeals considered two issues: (1) whether Reliable's failure to give Olson reasonable notice of the bankruptcy confirmation hearing constituted a denial of due process; and (2) if there was a denial of due process, whether the district court erred by finding Olson's claim not to be subject to the Plan and, thus, not dischargeable.

Issue of Adequate Notice

In its discussion, the court of appeals considered first the provision of the Bankruptcy Code contained in Section 1128(a): "After notice, the court shall hold a hearing on confirmation of a plan."[11] The court noted that this section "requires notice to be given to all parties in interest."[12] After Olson filed the counterclaim against Reliable on December 23, 1980, Reliable was put on notice of Olson's status as a potential creditor, but nonetheless, "no formal notice of any kind regarding the reorganization proceedings, or the time and manner of filing a claim, was ever given to Olson prior to the confirmation hearing."[13]

Although not raised below, Reliable's attorney at oral argument contended that Olson was adequately notified because its attorney had actual knowledge of the reorganization proceeding. Since this issue touched upon the serious question of due process of law, the court decided to consider it even though it had not been raised in the lower courts.

The court cited the Supreme

[8] See Bankruptcy Rule 3004.
[9] Reliable, 726 F.2d at 621.
[10] *Id.* at 621-622.
[11] 11 U.S.C. § 1128(a).
[12] Reliable, 726 F.2d at 622.
[13] *Id.*

Court's language in *Mullane v. Central Hanover Trust Co.*[14]:

> An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.

The court of appeals then relied on *New York v. New York, New Haven & Hartford R.R. Co.*[15] in observing:

> As specifically applied to bankruptcy reorganization proceedings, the [Supreme] Court has held that a creditor, who has general knowledge of a debtor's reorganization proceeding, has no duty to inquire about further court action. The creditor has a "right to assume" that he will receive all of the notices required by statute before his claim is forever barred.[16]

Having concluded that Olson was denied due process, the court of appeals considered Reliable's primary contentions: (1) even if Olson was not given the requisite notice, Olson was still subject to the confirmed Plan as were all creditors since Section 1141(d) of the Code "discharges *all* claims, whether a proof of claim has been filed, whether such claim is allowed, or whether the claimholder has accepted the plan"[17]; and (2) an "all-encompassing discharge is necessary to meet the purpose of reorganization to give the debtor a 'fresh start.' "[18] In essence, Reliable contended that Olson's only remedy for not receiving adequate notice of the confirmation hearing is that it may file a late claim under the confirmed plan.

The court did not dispute the all-embracing effect of the discharge provisions of the Code but required a discharge to be grounded on notice.

> Sections 1141(c) and 1141(d) ostensibly allow *any* claim to be discharged even though the claimholder has not received notice of the proceeding or of the confirmation hearing. However, we hold that notwithstanding the language of Section 1141, the discharge of a claim without reasonable notice of the confirmation hearing is violative of the Fifth Amendment to the United States Constitution.[19]

The court rejected Reliable's argument that even if Olson had opposed the Plan, it still would have had the approval of other creditors necessary for confirmation. Such "overwhelming approval" does not justify depriving Olson "of its guaranteed due pro-

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[14] 339 U.S. 306, 314 (1950).

[15] 344 U.S. 293 (1953). The court also cited *In re* Intaco Puerto Rico, Inc., 494 F.2d 94 (1st Cir. 1974), and *In re* Harbor Tank Storage Co., Inc., 385 F.2d 111 (3d Cir. 1967).

[16] 344 U.S. at 297.

[17] Reliable, 726 F.2d at 622.

[18] *Id.* at 623.

[19] *Id.*

cess."[20] Moreover, Reliable's reliance on cases[21] under the former Bankruptcy Act holding that deficient notice of the confirmation hearing and the date for filing claims still rendered the creditors' claims subject to the confirmed Plan and discharge was not convincing since they were decided prior to the Supreme Court's decision in the *New York* case and were not controlling.

Addressing the contention that affirming the finding of the district court "would defeat the purpose of Chapter 11—to give the bankrupt debtor a 'fresh start,' "[22] the court reiterated its previous holding: "As we noted in the text of this opinion, Sections 1141(c) and 1141(d) do appear to be 'all-encompassing' as applied to creditors' claims. Even so, Olson's guaranteed right to due process is paramount under the circumstances presented in this case."[23] Accordingly, Olson's claim is not dischargeable in the reorganization case.

Conclusion

The court of appeals in *Reliable* applied due process principles and Section 1128(a) of the Bankruptcy Code to prevent the discharge in chapter 11 of debts owed to creditors who were not given adequate notice of the confirmation hearing. Mere knowledge of the commencement of the case is not sufficient when the giving of formal written notice is possible.

It is important to note that the court of appeals did not hold that direct, formal notice is necessary with respect to creditors who cannot be identified prior to the confirmation hearing. In fact, in *New York v. New York, New Haven & Hartford R.R. Co.*,[24] on which the court relied, the Supreme Court stated: "Notice by publication is a poor and sometimes a hopeless substitute for actual service of notice. . . . But when the names, interests and addresses of persons are unknown, plain necessity may cause a resort to publication."[25] It is only when a creditor is known by the debtor but is not scheduled or notified directly of the confirmation hearing, that reliance on publication is unacceptable. If no action had been instituted by Olson and Reliable sued to recover for breach of warranty *after* confirmation, is there any doubt that the counterclaim, if asserted by Olson at that time, would have been discharged since Reliable knew of no such claim?

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[20] *Id.* at 623 n.5.

[21] Evans v. Dearborn Mach. Movers Co., 200 F.2d 125 (6th Cir. 1953); North Am. Car Corp. v. Peerless Weighing & Vending Machs. Corp., 143 F.2d 938 (2d Cir. 1944); see Reliable, 726 F.2d at 623 n.6.

[22] Reliable, 726 F.2d 623 n.6.

[23] *Id.*

[24] 344 U.S. 293 (1953).

[25] *Id.* at 296; see also *In re* GAC Corp., 681 F.2d 1295 (11th Cir. 1982).